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Written Statement for the Subcommittee on Select Revenue Measures and Subcommittee on Oversight

House Ways and Means Committee

Hearing on Maritime Tax Issues and Harbor Maintenance Funding

February 15, 2012

Introduction

This written statement is being provided to the Subcommittee for inclusion in the printed record of the February 1, 2012, hearing on harbor maintenance funding and maritime tax issues. This statement is submitted on behalf of APL Limited and affiliated companies ("APL"); Maersk Inc. and Subsidiaries ("Maersk"); Sealift Incorporated ("Sealift"); and Hapag-Lloyd AG and affiliated companies ("Hapag"); all U.S. corporations, in respect of maritime tax issues. In particular, this statement is provided in response to the Internal Revenue Service's ("IRS") inappropriate and narrow interpretations of the tonnage tax provisions applicable to U.S. flag vessels competing in foreign trade. The tonnage tax provisions were added to the Internal Revenue Code (the "Code") by the American Jobs Creation Act of 2004 in order to reverse the "steady and substantial decline of the U.S. shipping industry" and to level the playing field with tax-advantaged operators of foreign flag vessels. Today, the overwhelming majority of cargo, in

excess of 95%, continues to move in and out of the United States on foreign flag vessels. Congressional action now to stop the IRS's positions would safeguard the fulfillment of Congress's intent in enacting the tonnage tax provisions.

As Select Revenue Measures Subcommittee Chairman Tiberi stated: "The U.S. maritime industry is vital to our economy and national security. Today's tax code places preference on investment in foreign shipping operations over investment in domestic operations. . . . The Subcommittees should examine how to design tax policies that help create U.S. maritime jobs and that ensure the long-term growth of the domestic maritime industry." Maintenance of a U.S. flag fleet is of great importance to our national security. As General Duncan McNabb, Commander of the U.S. Transportation Command, said in 2011:

> Maintaining U.S. Flag sealift readiness is a top priority for the United States Transportation Command (USTRANSCOM). . . . USTRANSCOM's partnership with the U.S. commercial sealift industry is a vital component to meeting the Nation's strategic sealift requirements. To date, over 90 percent of all cargo to Afghanistan and Iraq has been moved by sea in U.S. Flag vessels.
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> [T]he Department of Defense (DoD) gains access to U.S. Flag commercial sealift and transportation networks while ensuring the continued viability of both the U.S. Flag fleet and the pool of citizen mariners who man those vessels. Any reductions [in the U.S. Flag fleet] will have to be offset in other ways to maintain current DoD sealift readiness.[1]

U.S. Flag Shipping Operations of APL, Maersk, Sealift and Hapag

APL is America's oldest shipping company and the world's seventh largest container transportation and shipping company, providing services across the globe through a network

[1] Letter from General Duncan J. McNabb, Commander of the U.S. Transportation Command, to Congressman Steven C. LaTourette (May 4, 2011).

combining intermodal freight transport operations with information technology and e-commerce. APL and its parent company, Neptune Orient Lines, currently own 16 U.S. flag vessels.

Maersk Line, Ltd. ("MLL"), a subsidiary of Maersk, owns or operates approximately 50 U.S. flag vessels either in international commercial service or under contract with the U.S. Government pursuant to various programs. Of these vessels, MLL operates approximately 16 vessels for the U.S. Government in preposition, surge sealift capacities, and special missions.

Sealift is an American shipping company based in Oyster Bay, New York. Sealift operates a fleet of 10 US flag ocean-going vessels most of which operate in its US flag liner service to world-wide destinations.

Hapag is a global container transportation company operating about 150 ships and five million containers with more than 80 liner services to all continents. Its subsidiary, Hapag-Lloyd USA, LLC, is a key supplier of end to end container transportation services to US government agencies and proudly operates six vessels under the US Flag.

Together, APL, Maersk, Sealift, and Hapag own or operate a substantial portion of the U.S. flag vessel fleet eligible for the tonnage tax provisions of the Code.

Overview of Tonnage Tax Provisions

In 2004, Congress made two significant changes to the Code to encourage American owned shipping. First, Congress introduced the tonnage tax provisions of the Code. Second, Congress repealed the so-called subpart F provisions of the Code concerning "foreign base company shipping income" applicable to controlled foreign corporations of U.S. companies.

The House Ways and Means Committee explained its reasons for enacting the tonnage tax provisions as follows:

> In general, operators of U.S. flag vessels in international trade are subject to higher taxes than their foreign-based competition. The uncompetitive U.S. taxation of shipping income has caused a steady and substantial decline of the U.S. shipping industry. The Committee believes that [the tonnage tax provisions] will provide operators of U.S. flag vessels in international trade the opportunity to be competitive with their tax-advantaged foreign competitors.[2]

When faced with other similar expressions of Congressional intent to encourage a particular activity, the courts have interpreted tax statutes in favor of the taxpayers that Congress intended to help.[3] Unfortunately, the IRS is interpreting the tonnage tax provisions in a manner that frustrates Congressional intent to allow U.S. flag vessels to compete with foreign competition.

Under the tonnage tax regime, the corporate income tax is imposed on a notional amount of taxable income determined on a per ton, per vessel rate. Actual gross income derived in respect of the U.S. flag shipping operations is excluded from gross income and associated deductions are disallowed. The tonnage tax regime is in Subchapter R (sections 1352 through 1359) of the Code.

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[2] H.R. Rep. No. 108-548, at 177 (2004). Similar reasons were provided for the repeal of the foreign base company shipping income rules. *Id*. at 209.

[3] *See, e.g.*, *United Telecomm. v. Comm'r*, 65 T.C. 278 (1975), *aff'd*, 589 F.2d 1381 (10th Cir. 1978), *cert. denied*, 442 U.S. 917 (1979) (noting that "because the investment credit provisions were enacted expressly to encourage investment in and modernization of facilities and equipment by reducing the net cost of acquiring assets, this Court and others have held that the investment credit provisions are to be liberally construed"); *Munson v. Comm'r*, 77 F.2d 849 (2d Cir. 1935) (concluding that under Merchant Marine Act, which allowed owners of U.S. vessels engaged in foreign trade to deduct the net earnings from such vessels so long as such owners invested a certain amount each year in building new vessels in the United States, the term "owner" should be construed broadly so as to allow the parent of eight subsidiary corporations to obtain such deduction, reasoning that such result would further the statutory purpose of encouraging investment in new ships, as a parent corporation could accumulate more quickly funds to build new vessels).

More specifically, section 1357 provides for exclusions of gross income from "qualifying shipping activities" derived by corporations in a tonnage tax electing group of corporations. Qualifying shipping activities relevantly include "core qualifying activities" ("Core") and qualifying secondary activities ("Secondary"). The exclusion for gross income from Core is unlimited (*i.e.*, 100% of a taxpayer's income from Core is excluded). However, the exclusion for gross income from Secondary is limited to 20% of the taxpayer's gross income from Core. Thus, whether a particular item of income falls within the definition of Core or Secondary activities is important to determining the amount of the exclusion from gross income.

Core activities is broadly defined as "activities in operating qualifying [U.S. flag] vessels in United States foreign trade."[4] A person is treated as operating any vessel that it owns, charters (including time charters), or provides services for pursuant to an operating agreement, as explained in greater detail below.

The Code provides a much more detailed definition of Secondary activities, which includes activities such as the provision of terminal, maintenance, repair, and logistical activities.[5] However, the entire definition of Secondary is subject to an important limitation that appears in the final flush language of the definition, namely, that in the event that a particular activity falls within the definition of both Core and Secondary, the activity is classified as Core and, therefore, is not subject to the 20% limitation on income from Secondary.[6] The definitions of Core and Secondary unequivocally establish that Congress understood that (1) vessel

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[4] I.R.C. § 1356(b).

[5] I.R.C. § 1356(c)(2).

[6] The final flush language of section 1356(c)(2) provides: "Such term [*i.e.*, 'secondary activities'] shall not include any core qualifying activities."

operators perform a wide variety of functions the income from which should receive favorable tax treatment as Core, and (2) there is an overlap in the definitions of Core and Secondary and that in such cases the definition of Core controls.

As a result of a 2005 technical correction, Congress confirmed that a taxpayer who provides services in respect of a vessel under an "operating agreement" is "treated as *operating* [a] vessel," and that activities such as crewing and performing technical services is included within the concept of "operating" a vessel.[7] Because Core is defined as "activities in *operating* qualifying [U.S. flag] vessels," the technical correction explicitly confirms that the provision of services pursuant to an operating agreement is Core.[8] Therefore, logic and common sense dictate

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[7] Emphasis added. As corrected, section 1355(b)(1) provides:

> For purposes of [subchapter R]—
>
> (1) In general.—Except as provided in paragraph (2) [relating to bareboat charters], *a person is treated as operating any vessel during any period if*—
>
> (A)(i) such vessel is owned by, or chartered (including a time charter) to, the person, or
>
> (ii) *the person provides services for such vessel pursuant to an operating agreement*, and
>
> (B) such vessel is in use as a qualifying vessel during such period.

(Emphasis added.) Gulf Opportunity Zone Act of 2005, P.L. 109-135, § 403(g)(1)(C).

[8] The Joint Committee on Taxation explains that the technical correction was meant to "clarify" the meaning of providing services under an operating agreement:

> The provision clarifies the treatment of operating agreements under the tonnage tax rules. An operating agreement is not a charter, but is instead an agreement with an owner or charterer of a qualifying vessel *to provide operating or management services* in respect of a qualifying vessel, *for example, crew, technical, or commercial services*. . . . [A] person providing services for a vessel under an operating agreement *is treated as operating the vessel* and may elect tonnage tax treatment, assuming the other requirements for such treatment are met. However, a subcontractor to a person providing services under an operating agreement is neither treated as providing services under an operating agreement nor as operating a vessel for purposes of the tonnage tax. The provision of equipment, tools, provisions, or supplies would not be considered an operating agreement or part of an operating agreement *unless such equipment, tools, provisions, or supplies are provided by the person providing the services under the operating agreement*, and such equipment, tools, provisions, or supplies are provided in connection with such services.

Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 4440, the "Gulf Opportunity Zone Act of 2005," as Passed by the House of Representatives and the Senate*, JCX-88-05 (Dec. 16, 2005), at 243 (hereinafter the "Bluebook"). Indeed, in enacting the "operating agreement" technical correction, Congress considered at least two examples of typical operating agreements provided to it: One was an operating agreement

that the definition of Core should be construed broadly and that the performance of activities of the type contemplated under an operating agreement should also be treated as Core when those activities are performed by a person owning or chartering a vessel.

Examples of IRS Positions that Frustrate Congress's Intent in Enacting the Tonnage Tax

The IRS is taking aggressive positions, narrowly interpreting the tonnage tax provisions and resolving any ambiguity in those provisions against taxpayers, despite Congress's clear statement of intent in enacting the provisions. The IRS's positions frustrate and directly conflict with Congress's intent in enacting the tonnage tax provisions to encourage American ownership and jobs and to level the playing field for U.S. flag shipping to compete with foreign flag shipping. In general, the IRS asserts that normal every day activities of a U.S. flag shipping company do not constitute Core "activities in operating qualifying [U.S. flag] vessels."

Specifically, the IRS is asserting that activities from the every day operation of ships are not Core, but are instead Secondary to which the 20% limitation described above applies, in a fashion that taxpayers and Congress could not have imagined. For example, the IRS is taking the following positions:

- Loading and unloading cargo to and from vessels, agency activities, providing a crew for vessels, crew training, maintenance and repair, opening and closing hatch covers, and even flag raising (!) are Secondary, and not Core;

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with the U.S. military in respect of the Ocean Surveillance (T-AGOS) and Range Instrumentation (T-AGM) fleet of vessels, and the other was the commercial Baltic and International Maritime Counsel (BIMCO) Standard Ship Management Agreement Code Name: "Shipman 98."

- Many activities pursuant to operating agreements, such as those entered into with the U.S. military, are Secondary (and not Core), even though the 2005 technical correction to the statute (described above) made it explicitly clear that income from providing services for a qualifying vessel pursuant to an operating agreement is Core;

- Income from Core is not gross income to the taxpayer, thereby lowering the amount of its income from Core activities and concomitantly lowering the amount of the taxpayer's exclusion for income from Secondary activities;

- The IRS has attempted to allocate certain deductions unfavorably[9]; and

- The IRS has ignored Congress's mandate to allocate income from Core activities among the members of a tonnage tax "electing group," thereby frustrating Congress's recognition that shipping companies frequently choose to conduct their operations through separate legal entities within a single group, rather than only through a single legal entity with several branches.[10]

By taking the above positions, the IRS both completely ignores the plain mandate of the statute – that in the event of an overlap between Core and Secondary, Core trumps – and the breadth of the definition of Core. Under the IRS's strained interpretation of Core, the only activities that would be covered by Core are most (but apparently not even all!) "anchor up to

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[9] Section 1357(c)(1) disallows deductions with respect to any activity the income from which is excluded from gross income under the tonnage tax provisions.

[10] In this regard, Congress understood that separate entities in a shipping company group each perform functions that form an integral part of the group's activities in operating qualifying vessels in U.S. foreign trade. *See, e.g.*, I.R.C. §§ 1355(a)(2), 1356(e).

anchor down" activities.[11] Such an interpretation disregards, or perhaps reflects the IRS's misconceptions regarding, the every day activities that are part and parcel of operating a vessel.

Moreover, all of the income from activities that the IRS asserts is Secondary is exempt from U.S. taxation for non-U.S. flag carriers under section 883 of the Code (the reciprocal shipping income exemption) or a U.S. income tax treaty when derived by a qualifying foreign shipping company. The IRS position therefore not only maintains the unlevel playing field that Congress clearly intended to eliminate, but it also directly contradicts its own earlier determination of precisely what constitutes "shipping" activities.

The above positions being taken by the IRS substantially eviscerate the benefits that Congress intended to accord operators of U.S. flag vessels, leaving them vulnerable to their "tax-advantaged foreign competitors." We believe that the above positions being taken by the IRS must stop if U.S. flag shipping companies are going to be able to compete effectively with foreign flag shipping.

Relief Sought

We understand that the IRS is currently working on informal technical guidance to be provided to IRS agents in the field to reinforce the above stated questionable positions.

We urge Congress to work with the Treasury Department to stop the IRS's unreasonable interpretations and, if necessary, to enact a technical correction to the tonnage tax provisions. The technical correction would specify and implement Congress's original intent that income items derived in the day-to-day operations of a shipping company from its consignors,

[11] The IRS's interpretations would also place significant administrative burdens on operators of U.S. flag vessels, requiring them to make difficult allocations between Core and Secondary in respect of activities that are part of operating vessels.

consignees, shippers, and alliance members is income from Core.[12] Such action would achieve Congress's intent of leveling the tax playing field for U.S. shipping companies, thereby helping to ensure the continued existence of a U.S. flag fleet to be available to the United States in time of war or for other national security reasons.

[12] If desired, we would be pleased to provide suggested legislative language for the technical correction.